Crowdfunding – could it become a viable option for Hungarian small businesses?*

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Crowdfunding is a financing method in which a large number of private individuals or organisations can contribute small sums of money via web-based platforms to support cultural, sports-related, social, technological or business projects and ideas. Crowdfunding is a potential source of finance for the SME sector, in particular, for start-ups. Although crowdfunding volumes tend to increase rapidly in developed countries, they are still considered marginal in comparison to other forms of finance. The first crowdfunding platforms have emerged in Hungary as well. Investor confidence is a factor that could best facilitate the growth of the market, which requires a well-functioning business structure, transparency and adequate investor-protection rules.

JEL-codes: E44, G20, G24, G28

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1 Crowdfunding and its types

Crowdfunding is a rapidly growing, innovative, online phenomenon that is playing an increasingly important role worldwide in the implementation of creative ideas, cultural projects or, as the case may be, business concepts. With an explosion in the popularity of social networking sites since the second half of the 2000s, numerous enterprises, budding entrepreneurs and artists have found an opportunity to launch a venture, gain recognition and make a career leap via crowdfunding project platforms. The launch of a new idea or a venture is typically financed by a narrow group of three participants: friends, family and acquaintances who, despite the high risks involved, are willing to fund novel projects primarily by virtue of personal involvement. By gaining new ground with online

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communities, this narrow group expanded spectacularly, opening up the possibility for involving a far more extensive range of people in bringing new ideas to life. The websites created for this particular purpose have propelled the crowdfunding model into the limelight.

Crowdfunding has several types, depending on their proximity to traditional bank and capital market financing forms. Accordingly, there are non-profit (donation or reward-based), unsecured loan (peer-to-peer lending or direct funding of ventures), equity-based or bond-based financing types. In exchange for their contributions to the fundraising campaigns, sponsors receive a return that matches the specific type of crowdfunding:

- Donation-based crowdfunding: there is no return. This type is typically used by artistic or social initiatives to recruit backers.
- Reward-based crowdfunding: most often, donors receive a small-value gift (as a souvenir or token of gratitude, perhaps participation at the event co-sponsored by them, or a copy of the end-product).
- Lending-based crowdfunding: backers are given a predetermined interest rate, which can be also guaranteed by the platform itself.
- Equity-based crowdfunding: supporters acquire a stake in a security. Returns are paid in the form of dividend or capital gain.

Table 1
Crowdfunding models

	Non-profit		**Business**	
Types	Donation	Reward	Lending – Peer-to-peer – Direct peer-to-business lending	Investment – Capital – Capital type
Characteristics	Philanthropic in nature; funders donate without expecting monetary compensation Unable to raise substantial capital	Promises non-financial gains Limited accountability Unable to raise substantial capital	Loan agreement, whereby the loan is repaid with interest Capable of raising substantial capital High-risk investments	Profit-sharing arrangements; stock or bond-type investment Capable of raising substantial capital High-risk investments

Note: Within the business models, another less common type of financing can be distinguished: royalty-based funding.
Source: ESMA/2014/CFSC/23

At first glance, the equity-type crowdfunding model is very similar in character to the functioning of venture capital. This form of financing is typically (but not exclusively) used by start-ups wishing to raise funds. However, the method of raising capital, the targeted investors and the entire regulatory environment are all very different, compared to venture capital investment. In the case of equity-type crowdfunding transactions, it is the online platform that announces the campaign and arranges the transaction between the issuer as the capital requestor and (mainly) private individual investors as the source of capital. The entire deal is governed by the rules of the website concerned. If the target amount has been collected, the platform pays it out to the issuer at the end of the prespecified fundraising period. As such, the platform organises the primary issuance only.

Lending-based crowdfunding is commonly compared to microfinance/social lending as well, even though these two models differ in fundamental ways. Microfinance usually targets people in lower social classes, typically implying small-value, low-volume lending. At the same time, the social aspect of microfinance is not very significant in Hungary or other Central and Eastern European countries; basically, it is an important form of access to funding for micro- and small enterprises with a broader range of loan objectives. On the one hand, crowdfunding does not restrict loan objectives and the group of debtors; on the other hand, it has a preference for technology-intensive lending objectives. Thirdly, crowdfunding puts large loan amounts within reach.

One of the greatest advantages of crowdfunding is that it gives the SME sector access to funding. Since the SME sector contributes significantly to GDP and employment worldwide, it is important for innovative, high-growth potential firms to have access to the funds required for their growth. It is no accident that community finance embarked on a rapid growth path in 2008, after the outbreak of the crisis. Indeed, it was then that banks' lending capacity and willingness to lend declined, and capital market borrowing opportunities dwindled.

For investors, the investments available on finance platforms give access to completely new, exposed risks. This creates a new investment instrument class and provides new diversification opportunities. The efficient distribution of risks between investment instruments may contribute to the reduction of systemic risks.

One common feature of the platforms is that they operate on the Internet; therefore, in their case there is no need for physical presence or traditional financial intermediaries. As borrowers are typically rated automatically according to predefined parameters, the labour requirement is also lower, compared to mainstream financing channels. As a result, the platforms can achieve a significant cost advantage, which allows for inexpensive and efficient financial mediation.

As new market entrants, the platforms generate competition for institutions offering traditional financing options, prompting them to improve their services and provide faster and cheaper customer service.

2 How big is the market today?

Since 2008, crowdfunding has been growing rapidly. By 2013, the number of different online platforms exceeded 800 worldwide, with tens of thousands of initiatives having received funds from millions of backers. As regards financing volumes, in 2013 donation-based platforms still accounted for more than half of funds raised. By 2013, the volume of funds provided by the business branch of the industry rose to USD 6.4 billion, and this segment has remained a striving business to this day. It is developing dynamically, doubling the funds raised each year, with the USA (51%), UK (17%) and China (28%) boasting the largest share in the market (ESMA [2014]).

This new form of finance continues its triumphant march across the world, presaging further dynamic growth for the segment. The future success of the industry is largely influenced by the attitude of legislators and supervisions toward crowdfunding. Provided that an adequate level of regulation is enacted, crowdfunding may well become an important segment of the financing of SMEs and start-ups. The typical target amount is quite varied, ranging between USD 1,000–1,000,000. The total market potential of crowdfunding is estimated to grow up to USD 90 billion per year by 2025 (World Bank [2013]).

Owing to a well-developed Internet culture and a large internal market, online-based campaigns for social or fundraising purposes have particularly flourished in the United States, with numerous online platforms involved in announcing projects, promoting the model and communicating successful campaigns. An indicator of the effectiveness of platforms is the percentage of successful projects within their fundraising campaigns (i.e. whether the funding target has been achieved). The most dynamically growing donation-based crowdfunding platform in the United States is Kickstarter. It started operations in 2008, and since then it has raised more than USD 850 billion for approximately 50,000 projects with a project success rate of 44 per cent. The second most successful US crowdfunding platform is Indiegogo, which collected, for example, USD 36,918 for the production of Feel Flux, a new physics-based toy developed by two Hungarian young men.

After the economic crisis of 2009, crowdfunding gained large momentum in Europe as well. In Hungary, the first crowdfunding platforms were launched in 2012 (*Creative Selector* and *Indulj.be*), but so far they have only a handful of successful projects under their belt.

Table 2
Number of crowdfunding platforms in selected countries

Country	# of CFI Platforms	Country	# of CFI Platforms
United States	344	Brazil	17
France	63	Canada	34
Italy	15	Australia	12
United Kingdom	37	South Africa	4
Spain	27	India	10
Netherlands	34	Russian Federation	4
Germany	26	Belgium	1
		Hong Kong SAR, China	1
		China	1
		United Arab Emirates	1
		Estonia	1

Source: World Bank (2013)

3 Significant risk factors

Despite its advantages, crowdfunding comes with significant risks to the investor. Although some of the risks can be mitigated by regulatory protection and adequate platforms, it is still a high-risk product. The most significant risks are lending risks and counterparty risks. These can be partly mitigated by the platform if on the one hand it performs some pre-screening among those offering potential investment opportunities and on the other hand assumes certain settlement services in respect to investment quotes and financial settlements. Although individual platforms have widely diverging practices in this regard, numerous platforms have shifted to a practice aimed at mitigating the risk of the debtor's default or delinquent fulfilment. As a result, on the US-based Lending Club platform, only one in ten requestors gains access to capital. Similarly, different platforms and countries report different default rates. In the USA, the average default rate has dropped significantly from the 30 per cent level recorded in the mid-2000s. The default rate reported by the most successful platforms now ranges between 3 per cent and 7 per cent, according to the International Organisation of Securities Commissions (IOSCO).

The second most important risk is fraud and the investor's lack of sufficient information about the projects. It is easy for those with fraudulent motivations to take advantage of the lack of a personal relationship. Since platforms operate solely through the Internet and credit rating is, for the most part, an automated process where data provided by the borrower are not always verified, there is a higher chance of information asymmetry or intentional fraud. Investors are often unable to assess the true level of the risks associated with the investment. For proper functioning of crowdfunding, stricter enforcement of information disclosure rules is indispensable, and this requires a set of special rules.

The online operation of the platforms and the lack of personal contact entail elevated money laundering risks, both on the side of investors and on the side of borrowers, compared to the traditional financial intermediary system.

Another noteworthy risk factor is liquidity risk. Investments made on crowdfunding platforms are typically completely illiquid; in other words, investors have no exit options before maturity. Stocks and bonds platforms are basically primary market portals; secondary trading with securities (such as on a stock-exchange) is, for the most part, extremely limited with a high cost of sale.[1]

Finally, operational risks are also included among the most important risk factors. These may stem either from fraud or from certain characteristics of platforms that are inherently associated with key risks. As most platforms are small ventures with limited resources, presumably they operate with weaker controls and enterprise management systems, compared to the standards of the financial services industry.

These risks are expected to be more pronounced in Hungary than in more developed regions. High risks and a lack of business confidence may forestall any meaningful development of this form of finance. This stumbling block could be lifted by high-quality regulations and a sound operating structure (model).

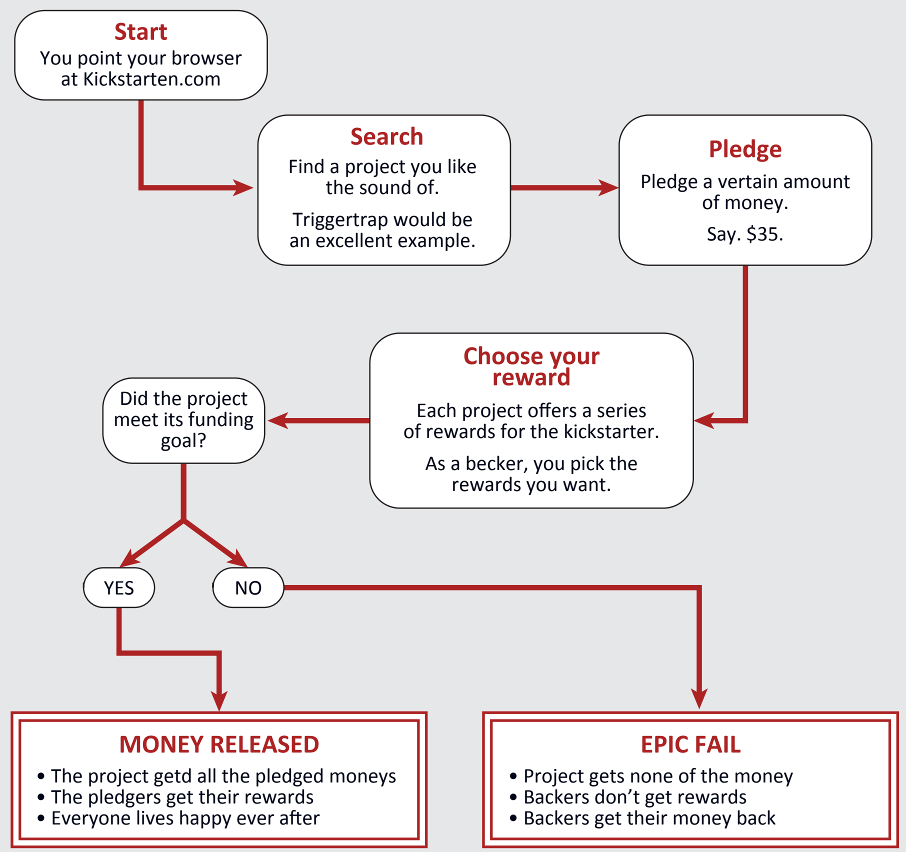
4 How do the most successful platforms work?

4.1 Kickstarter

Kickstarter has been already mentioned above as the most important crowdfunding site by international standards. The mission of the enterprise is to support the projects and ideas of creative project owners, artists, inventors and innovators. Kickstarter is a so-called donation-based online platform, where backers cannot become investors or shareholders and they do not expect anything in return for their contributions.

1 See, for example, the section presenting the operation of Lending Club.

Chart 1
The business model of Kickstarter



Source: www.triggertrap.com (http://triggertrap.com/launching-on-kickstarter/)

Successful projects rely on excellent ideas and products, as they are the drivers that can lift and bring a project to fruition. For instance, the Pebble smartwatch elicited enormous popularity and raised USD 10 million. The most funded Kickstarter campaign in history was Ouya, an android-based gaming console, which raised more than USD 1 million in 8.5 hours and over USD 8.5 million in total. The platform charges a 5 per cent fee on the funds collected.

Kickstarter commenced its international expansion in 2012 by first entering the market in the United Kingdom. It then gained a foothold in Canada, Australia and New Zealand in 2013.

4.2 Lending Club[2]

Lending Club is an online credit marketplace, bringing together borrowers and investors through the cutting-edge technology and financial innovation offered by the platform. The goal of the US-based firm is to bring about a radical change in lending by making it more inexpensive, transparent and consumer-friendly. Since its opening in 2007, Lending Club has facilitated more than 230,000 loans at a total value of USD 3.2 billion; the company currently has more than 400 employees. Besides operating the web portal, the company provides numerous background services to facilitate lending. For instance, it examines the credit score of applicants and provides services that expedite the performance of payment obligations.

Basically, the platform provides access to two loan products. It offers personal loans for private individuals from USD 1,000 up to USD 35,000. These loans have a fixed interest rate and a maturity of 3 or 5 years. Applicants must have a predetermined credit score in order to be granted a personal loan. Investors (creditors) purchase small loan portions ("notes") in the form of bonds. In essence, this implies the securitisation of small-amount loans. In 2014, a new product was introduced, the small business loan, available in amounts ranging between USD 15,000 and USD 100,000, with a fixed interest rate and maturities between one and five years.

In the credit market, the platform competes primarily with banks. Since it operates with no physical branch infrastructure, relying essentially on online technologies, it can achieve efficient operation and a cost advantage. From the aspect of investors, the service competes with mainstream investment options (e.g. bank deposits, bonds, stocks, mutual funds). For investors, the advantages emphasised by the platform are flexibility, easy diversification, the possibility to earn solid returns in a risk-reward model and investment opportunities unlike any available through traditional means.

All loans are provided by the platform's credit institution partner (WebBank), which receives a commission from the platform in exchange for its services. Lending rates and origination fees are determined in relation to the borrower's credit risk, which is calculated on the basis of the platform's own loan grading model.

Loans are financed in three different ways:

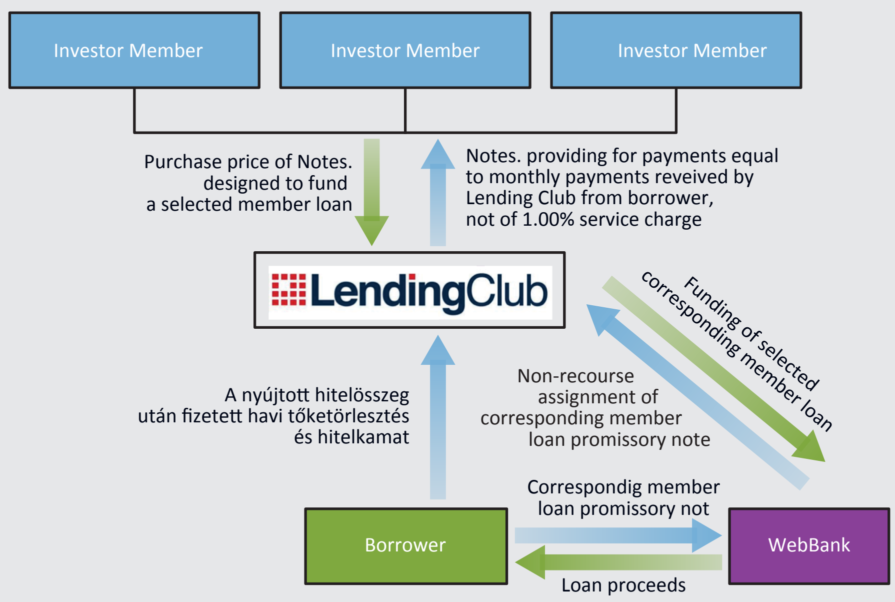
1. Open bond issue: by way of a public prospectus, notes are offered through the website to anyone interested. Notes are issued by the platform's operator, Lending Club itself. Each series of notes is backed by a single loan facilitated through the platform. Interest and principal are repaid fully from the cash flows stemming from the payments associated with the underlying loan.

2 The decription based on the Lending Club's webpage and the prospectus approved by the SEC.

2. Private security offering: targeting accredited investors, securities are issued from time to time in a private procedure where, similar to public issuance, the sole collateral for the securities is the repayment of the underlying loan.

3. Loan trading to third parties: even in this case, clients are served through the platform itself.

Chart 2
The business model of Lending Club



Source: www.lendingclub.com

Lending Club has massive information technology support at its disposal, with fully automated systems in the following areas: client acquisition, registration, subscription, payment cycles and electronic account monitoring system.

Given that the company offers complex financial services through its lending and security issuance services, its activity is strictly regulated and supervised and is subject to prior authorisation.

The first step of the investment process is investors' registration. During the registration process, investors are identified and offered to sign an investment contract that includes provisions on the details of the note purchase. Investors must also comply with certain financial security and investor-protection rules (which vary from state to state) prescribing minimum requirements about the investor's annual income and net worth and defining the maximum threshold of individual investments. Investors may not spend more than 10 per cent of their net worth on the purchase of notes.

After registration, investors can search and browse the loan listings to decide which borrower to fund and by how much, indicating their commitment to invest in pieces of loans in USD 25 increments, up to the amount of free funds at their disposal. After confirmation of the investor's commitment, the order may not be cancelled and the funds may not be used for anything else.

In all cases, the actual creditor is WebBank, a credit institution licensed to sign the loan agreement. Upon submitting their request, potential borrowers disclose their annual income and place of employment, and give consent to the platform to obtain data from external credit rating agencies regarding their creditworthiness. Based on the data thus obtained, the platform determines the applicant's credit rating and shares all information (except the name of the borrower) with investors, who can decide on the basis of the information provided whether they wish to invest in the notes issued with the backing of the underlying loan.

The lending rates on individual loans are determined by a committee. They are based on the following criteria: general economic environment, the history of the supply-and-demand relationship between funds and borrowing needs on the platform, the expected default ratio associated with specific credit ratings, and the pricing of comparable products offered by competitors. Lending rates typically vary between 6 per cent and 26 per cent.

Once a loan request has received its credit grade rating and the committee has determined the corresponding interest rate, the listing is posted on the Lending Club website and becomes visible to potential investors. While investors do not see the borrower's name, the requested amount, the credit rating, the term of the loan, and the borrower's income and employment are publicly available on the website, along with confirmation of whether this information has been verified. Investors can also see other investors' subscription offers to date and the loan purpose indicated by the borrower. Investors also have access to information provided by external credit rating agencies (credit bureaus). This information about the loan and the borrower, pertaining to the issue of the note, is published in the form of a prospectus supplement. As such, its disclosure rules are governed by those applicable to the prospectus, and they include the appropriate risk warnings.

Loan requests are posted on the platform for a maximum of 14 days; investors have this period to indicate their commitment to order. If applicants fail to receive full funding during that period, they may request relisting of their request, up to the amount yet to be funded. When the listing is closed, WebBank pays the requested loan amount to the borrower, using Lending Club as the payment designee, and assigns the loan to Lending Club. Upon issue of the notes, the purchase price (face value) of the notes is deducted from the investors' accounts. In case of a successful disbursement, the borrower pays an origination fee, which is deducted from the disbursed amount.

Secondary market trading of the notes is restricted. Investors may only sell the notes on a trading platform set up for this particular purpose and operated by a non-affiliated investment service provider, which charges 1 per cent for the transaction.

Monthly repayment information is sent to investors and the external credit bureaus. In the case of late payment, an arrangement may be made to reschedule the debt, even without the consent of noteholder investors. The portal declares the payment to be delinquent on the website on the 31st day of delinquency, at which point it is referred to either an internal or third-party debt collection agency.

4.3 Crowdcube

Crowdcube, which has grown to become the UK's largest and the world's leading equity-type crowdfunding platform, launched its portal in 2011. Its fundamental goal is to help British businesses raise money. Providing an alternative for banking services besides so-called "business angels" and venture capitalists, the portal gives start-ups an opportunity to finance their projects through funds contributed by investors. In essence, anyone can invest capital in early-stage and growth businesses via the Crowdcube portal in exchange for a commensurate equity stake in the business they helped fund. Enterprises seeking funding on the Crowdcube platform are invited to introduce their planned projects and the business opportunities they entail to thousands of investors. In the case of a successful fundraising campaign, Crowdcube charges a 5 per cent success fee. Approximately GBP 30 million has been invested via the platform to date (GBP 15 million of which was raised in 2014). Crowdcube has 80,000 registered users and has raised funding for 131,000 businesses so far. The technology sector has proved to be the most popular segment of start-up and growth-stage companies.

Crowdcube has obtained a supervisory license for its activities from the British supervisory authority. Thanks to its supervisory license, Crowdcube's clients are protected by the investor protection fund and, in certain cases, they can also turn to the Financial Ombudsman Service.

During their activity on Crowdcube, investors acquire an equity stake – in the form of securities – in the company that they have funded. Obviously, such investments in start-ups entail significant risks; however, they promise fairly large potential returns. No middleman is involved in the process; investors become direct legal shareholders. In addition, once funded, the British platform continues to monitor the progress of the business concerned, provides consulting services during security issuance, and supports the firm in any other professional matters, as required.

The issue of mini-bonds is another way of borrowing capital on Crowdcube. The mini-bond product enables start-up or growth-stage businesses to borrow expansion capital from their stakeholders, customers or even entire investor communities. The company determines the annual fixed interest rate of the bond to be issued (typically between 6 and 8 per cent) and the maturity of the bond (usually up to 5 years). As is the case with other bonds, the issuer then receives the growth finance they need, which they repay gradually during the term of the bond at a predetermined interest rate. Participants can benefit from the transaction in various ways, while the business has an opportunity, among other things, to build a stronger relationship with its customers. At the same time, the portal calls attention to the fact that mini-bonds are unsecured, non-convertible and non-transferable – and, as such, they carry high risks.

In February 2014, the popular British crowdfunding platform set up the Crowdcube Venture Fund, offering investors a higher level of protection by teaming up with an independent, professional fund manager to manage and monitor their start-up portfolios while also taking into account tax-efficiency considerations.

At the beginning of the campaign, businesses seeking to raise capital create their own page (i.e. pitch) on the Crowdcube portal. In order to do this, they need to submit an online application, to which they attach a business plan, a summary of their investment proposition, and a financial forecast for the next three years. Next, Crowdcube examines whether the company meets the criteria set by the investors of the platform and considers the success of the enterprise so far. This review process takes about two to three weeks.

After the application has been accepted, the company creates its pitch, uploading an introductory video and other documents containing financial information. In order to attract investors, it is important to include as much relevant information as possible, along with creative, interesting elements to raise attention. If the company's pitch is approved by Crowdcube, it will be activated, and the collection of the target amount begins.

Once the campaign goal has been reached, the funds are disbursed to the company (this process takes about seven days), and an investor schedule is drawn up, specifying the number of shares to be issued. Finally, the securities are issued.

In order to protect both sides, Crowdcube performs background checks and uses rigorous anti-money laundering controls in respect to both investors and businesses.

5 Regulatory needs

5.1 United States

The United States responded quickly to the regulatory needs of crowdfunding. By 2012, the business-friendly society of the USA pushed through a change in the rigid rules of security issuance, and the impediments of the simplified, Internet-based, small-volume borrowing of early-stage businesses have been removed. The regulator focuses on the portal and the investor, while minimum compliance is prescribed for issuers. For start-ups, it is key that they are not bound by any (rigorous) preliminary licensing obligation, which cannot be avoided during initial public offerings. Start-ups are early-stage enterprises mostly built around a business idea; they would have difficulties complying with any indicators and would not be able to produce the documentation required for an IPO. Therefore, start-ups are only able to launch fundraising campaigns on crowdfunding portals because they are subject to different rules than their peers in traditional financial markets.

Adopted in April 2012, the *Jumpstart Our Business Startups Act* (abbreviated as the JOBS Act) lays down certain crowdfunding exemptions. These exemptions allow companies to launch fundraising campaigns with significantly more relaxed and less stringent rules, provided that during the campaign they meet the set criteria defined in the JOBS Act.

Firstly, the JOBS Act sets restrictions on transaction volumes, both in terms of the aggregate volume of the issuance and in terms of the volume allowed to be sold to a single investor (from the point of view of investor protection).[3]

Another requirement of the transactions is that they should be facilitated by a broker or a so-called funding portal that complies with the criteria presented below. In addition, investors must also comply with a predefined set of criteria.

Main requirements for platforms

3 The total dollar amount of the securities being sold by an issuer may not exceed USD 1 million over a 12-month period. Over the course of a 12-month period, investors are permitted to invest up to:
- USD 2,000 or 5 per cent of their annual income (or net worth, defined as assets less liabilities), whichever is greater, if their annual income (or net worth) is less than USD 100,000;
- 10 per cent of their annual income (or net worth), whichever is greater, if either their annual income (or net worth) is equal to or more than USD 100,000.

In order to be compliant, intermediaries must be registered, either as a broker or as a funding portal, with the SEC (Securities and Exchange Commission, the US security supervising authority) and any applicable self-regulatory organisations (SRO). Intermediaries disclose all information on the investment deemed appropriate by the SEC and at the same time ensure that:

- each investor reviews investor-education information;
- all relevant information provided by the issuer is made available to the SEC and to potential investors no later than 21 days prior to the first day on which securities are sold;
- the investor confirms its understanding that it is risking loss of the entire investment and that the investor's financial position could bear such a loss;
- each investor answers questions demonstrating an understanding of the level of risk generally applicable to investments in start-ups and small issuers and an understanding of the risk of illiquidity;
- appropriate measures are taken to reduce the risk of fraud with respect to the transactions;
- all offering proceeds are only provided to the issuer when the aggregate capital raised from investors is equal to or greater than the target offering amount, and all investors are allowed to cancel their commitments to invest if the funds raised does not reach the original target amount;
- continuous monitoring is in place to ensure that no investor exceeds the investment limits referred to above;
- the privacy of information obtained from investors is protected;
- their directors, officers and partners are prohibited from having any financial interest in an issuer using their intermediary services.

Main requirements for issuers

Issuers must provide or make available to the SEC, investors and the relevant broker or funding portal the following information:

- the name, legal status, physical address/registered seat and website address of the issuer;
- the names of the directors, officers and each person holding more than 20 per cent of the shares of the issuer;

- a description of the business of the issuer and the anticipated business plan of the issuer;
- a detailed description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
- the target offering amount and the deadline to reach the target offering amount; the issuer must provide investors with regular updates regarding the progress of the campaign;
- the price of the securities to the public or the method for determining the price, provided that, prior to sale, each investor is provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;
- a description of the ownership and capital structure of the issuer;
- a filing with the SEC not less than annually and reports to investors of the results of operations and financial statements of the issuer.

5.2 European regulatory initiatives

European governments also turned their attention to crowdfunding as an alternative form of finance targeting small businesses, as companies in this segment notoriously struggle with a lack of capital. With the involvement of market participants, the European Commission has drawn up an action plan to stimulate long-term financing opportunities, including crowdfunding, in order to facilitate economic growth (European Commission [2014]).

Some Western European countries have already taken some independent regulatory steps; however, the phenomenon is not treated in a uniform manner everywhere.

The general regulatory framework in effect across the European Union is currently composed of the following rules.

Three EU directives are connected to crowdfunding regulations: the Markets in Financial Instruments Directive (MiFID), the Prospectus Directive (PD), and the Alternative Investment Fund Managers Directive (AIFMD). The directives on credit institutions and the Payment Services Directive (PSD) are applicable to lending-based crowdfunding, depending on whether the platforms collect money from clients or execute payments.

To date, regulations do not include specific provisions on crowdfunding. It is noteworthy that there is not a single definition for crowdfunding in Europe, and it is unclear what kinds of services crowdfunding platforms are expected to provide.

At present, the European Banking Authority and the European Security Market Authority work together to ensure a clearer understanding of how the current regulatory framework is applicable to crowdfunding and to facilitate a higher level of supervisory convergence in the EU. The European Commission is exploring the potential and the risks of crowdfunding, as well as the national legal frameworks applicable to it, in order to identify whether value is added at the European level in terms of policy action in this field.[4]

5.2.1 Italy

In Italy, crowdfunding-related activity is regulated by a decree entitled "The collection of risk capital on the part of innovative start-ups via on-line portals,"[5] which was adopted in June 2013.

Registration requirements have been defined for crowdfunding portal managers and for start-ups seeking funds via the platform. For the registration of businesses, the following information must be provided in addition to general company data: a description of the business activity (business model) and organisational structure of the company, a list of all outsourced activities, information on controlling shareholders (with an indication of their stake, expressed both in monetary value and in percentages), and the name of the persons performing managerial and supervisory functions.

In operating the portals, portal managers must strive to ensure transparency, avoiding any conflicts of interest that may have a detrimental effect on the interests of the investors and the issuers. The portal manager must make available to the investors all of the information provided by the issuer regarding the offer. This information must be disclosed in a comprehensive, detailed and straightforward manner in order to ensure that investors fully understand the nature of the investment and the associated risks, so that they can make informed decisions about the investment. Moreover, the portal manager must draw non-professional investors' attention to the fact that the investment entails high risks and, as such, their investment should be proportionate to their financial resources. The portal manager must refrain from expressing recommendations in respect to the investment offers listed on the platform.

4 http://ec.europa.eu/internal_market/finances/crowdfunding/index_en.htm

5 Delibera n. 18592 "Regolamento sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line"

The portal manager must provide to investors, in a concise and easily comprehensible form, all of the information related to investments in innovative start-ups, including:

- the risk of losing the entire invested capital;
- the risk that it may be impossible to cash in on the investment immediately;
- the taxation benefits applicable to the investment;
- the contents of the specific company's business plan.

The portal manager must also ensure that non-professional investors may only access the sections of the portal where it is possible to pledge a contribution to a specific investment offer if they have:

- read the information related to the investment;
- answered positively to a questionnaire that is intended to demonstrate full understanding of the essential features and main risks related to investment in innovative start-ups via portals;
- clearly declared that their financial position would be able to sustain the entire loss of the investment.

Banks and/or investment firms processing orders must inform the portal manager on a continuous basis of the progress of the investment offer. For each individual order, the portal manager must ensure that the funding necessary for the processing of the offer is deposited in the account held on behalf of the issuer at the bank or the investment firm to which the orders are transmitted.

Non-professional investors who have expressed their commitment to purchase a financial instrument via a portal must be ensured of the right to revoke their order if at any time between pledging their commitment and the closure of the offer, a new fact arises or a relevant material mistake occurs vis-à-vis the information provided on the portal that could influence their decision regarding the investment. The revocation right can be exercised within seven days from the date on which the investor obtained knowledge of the new information. If the investor exercises its right of revocation, the invested amount must be fully refunded to the investor.

5.2.2 United Kingdom, France and Germany

The operation of peer-to-peer (P2P) lending platforms is a regulated activity, falling within the scope of the Financial Services and Markets Act 2000 (Section 36H; effective from 1 April 2014). The activity is subject to supervision; however, it is not covered by the local deposit guarantee scheme.

The regulation defines customer information, complaint management and capital requirements, and determines the maximum loan amount to be GBP 25,000.

Loan agreements via the platforms are concluded between the creditor and the borrower; terms are standardised. RateSetter manages the risk of late payment and default by using its "Provision Fund".[6]

In France, the most widely known platform is Prêt d'Union, which is authorised by the French supervisory authority[7] to carry out broker and credit institution activities. The platform enables private individuals and institutions to provide loans by way of covered bonds.

The development of independent regulation pertaining to these platforms is in progress, with a view to ensuring consumer protection and transparency. The regulation is expected to cover disclosure requirements and to establish the relevant special legal status (*intermédiaire en financement participatif*). In addition, the draft legislation sets an overall investment ceiling (EUR 1 million) and limits the amount a lender can invest in any particular loan (EUR 1,000).

In Germany, crowdfunding platforms are not regulated by independent legislation; they are subject to bank regulations. The market leaders, AUXMONEY and Bergfürst, pursue their activities in possession of a banking license.

6 Hungarian opportunities

For a more thorough exploration of domestic opportunities, it is necessary to examine both the borrowing requirement and the prevailing legislative background.

Examining developments in investment/equity ratios (excluding the amortisation effect) of micro- and small enterprises over nearly the past two decades, one finds that, apart from a couple of outliers, the annual investment activity of this segment follows a declining trend. This reconfirms the assumption of a need for innovative forms of borrowing.

As regards investor risks, the default ratio of micro- and small enterprises stabilised at an annual level of 3 per cent after the effects of the crisis wore off. This ratio implies that, in the case of a typical 5-year project, there is a 16 per cent[8] probability that the business

6 The Provision Fund functions as a guarantee fund, pooling funds from borrowers' payments. The purpose of the Fund is to cover losses stemming from potential borrower defaults.

7 Autorité des Marchés Financiers (AMF)

8 Based on values derived from Chart 4.

will go bankrupt during the lifecycle of the project. As the main targets of crowdfunding are new enterprises, the default rates of which are significantly higher than those of their older peers, the risks involved can be considered rather high.

Chart 3
Investment/equity ratios of micro and small enterprises
(excluding amortisation effects)

Source: MNB.

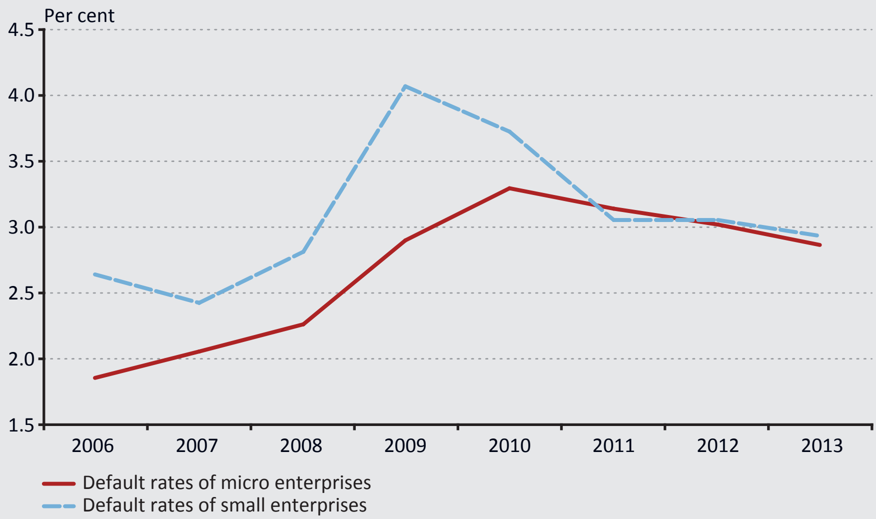
Since 2010, primarily owing to the venture capital funds backed by EU resources (JEREMIE programmes), venture capital funding available to SMEs increased substantially, expanding the range of funding available outside of the banking system. By the end of 2013, the share of JEREMIE funds in the HUF 215 billion subscribed capital of venture capital funds reached a total of HUF 132 billion. Crowdfunding could fit seamlessly in this system, especially in the JEREMIE programme. Already functioning venture capital funds could provide a good exit option for investors of small businesses supported by crowdfunding investments.

On the lending side, besides bank loans, the Funding for Growth Scheme eased supply constraints, and significant state programmes are in place in the area of microfinance (New Széchenyi Combined Micro Loan, New Széchenyi Loan, Széchenyi Card Overdraft, etc.). These programs have gained popularity, owing to their two main features: the preferential interest rates ensured by the state subsidy and, for the financial institutions providing the loans, the state guarantee programme, which is a significant risk-reducing instrument. These programmes generally require borrower companies to have a one- or two-year operating history. Based on the above, crowdfunding could have important potentials in the areas of equity finance and lending to companies without an operating history. In case of small start-ups, lending and investment risks are nearly equally high.[9] Accordingly, attention is focused on the potentials of crowdfunding in equity-based financing.

Although the Internet breaks down geographical barriers, international experience shows that businesses prefer to use crowdfunding platforms operating in the local regulatory environment. For the time being, there are no direct investment platforms ("regulated marketplace") in the CEE region that facilitate this form of borrowing. In Poland, joint work initiated by the Warsaw Stock Exchange (WSE) and aimed at the establishment of such a platform has been commenced by the institution, comprising 5,000 start-ups (Aula Polska) and the WSE, with a view towards improving the financing of enterprises and facilitating innovation.

Besides exploring current regulatory options, the question arises whether there is a need for developing *sui generis* rules, as was the case in the United Kingdom.

Chart 4
Default rates of micro- and small enterprises



Source: Opten.

9 The rare exception is the case when substantial assets are provided as contributions and the start-up commences operations in a well-capitalised position.

In Hungary, security trading is regulated by Act CXX of 2001 on the Capital Market (Tpt.). The provisions of the Tpt. are based on the principle that any marketing of securities in ways other than private offering are subject to regulations on public offerings.[10] According to one of the exemptions specified in the Act, the offering is considered private if the subscribed capital borrowed by the company does not exceed EUR 100,000 within a year. In such cases, regarding the capital collected within this limit through a campaign publicly available to anyone (which, however, must be a regulated process in full compliance with investor protection criteria), the issuer must only adhere to the rules of private offerings; in other words, the issuer does not have to submit a prospectus for the approval of the fundraising campaign. In theory, this may provide an opportunity for a portal involved in equity-based crowdfunding.

In view of the aforementioned provisions of the Tpt. and the relevant provisions of the Civil Code on limited companies – according to which only public companies are entitled to solicit capital by way of public invitation[11] – crowdfunding by way of security issuance appears to be feasible within the abovementioned framework of private offering. In respect to the above, however, it should be noted that, due to the company registration procedure and the origination of the shares (i.e. their production by means of dematerialised ways or printing), this form of raising funds may well become extremely costly relative to the volume issued (legal fees, fees charged by KELER Zrt, etc.). In addition, in the case of this form of crowdfunding, potential shareholders may subsequently incur further costs beyond the initial payment of membership capital.

As the example of US peer-to-peer lending demonstrates, besides the issuance of shares, the model can be also envisaged in the context of bond issuance.

As regards donation-based capital contributions, the relevant taxation obligations should be considered (e.g. VAT, corporate and dividend taxation), although they are primarily applicable to donations offered by business associations (for non-public purposes).

10 Pursuant to Section 14 (1), the private offering of debt securities is subject to the following criteria: "It shall be construed as a private offering (hereinafter referred to as "private offering") when:
a) securities are offered only to qualified investors;
b) securities are offered to less than one hundred and fifty persons in each Member State, and if these persons are not considered as qualified investors;
c) securities are offered to investors, each purchasing at least one hundred thousand euros, or its equivalent in any other currency, from the securities offered;
d) the face value of the securities offered is at least one hundred thousand euros, or its equivalent in any other currency; or
e) the total consideration for all securities in the Union included in the offer shall not exceed one hundred thousand euros, or its equivalent in any other currency, within twelve months from the date of announcement of the offer;
f) a limited company is created by the transformation of a cooperative society and its shares are offered only to the members and shareholders of the predecessor.

11 Pursuant to Section 3:249 of the Civil Code.

Several platforms operating abroad pursue activities that may be considered as loan mediation between the funders and the fundees; under the national law of the company's location, these may qualify as financial services. In Hungary, the pursuit of credit and loan operations and the provision of financial intermediation services on a commercial scale is subject to authorisation (pursuant to the provisions of Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises).

Upon developing a domestic model, consistency must be ensured regarding regulations pertaining to money laundering and terrorist financing (Act CXXXVI of 2007), which prescribe customer identification, the reporting of suspicion of money-laundering transactions, etc. This is particularly important in this case, given that platforms are Internet-based with no personal contact involved.

The registered capital portal defines the details of its operational processes. In line with international examples, the legislator's main focus is the protection of investors. The venue of capital raising and its supervision must be determined; transparency must be ensured and investor protection control must be put in place. The goal should be to ensure that the transformation of the regulation does not result in dilution and less investor protection; it should only remove the biggest obstacles from the path of the new institution.

Investor protection should basically cover the following key areas:

1) On the investor side:

– setting the upper limit of the investment and determining the size of the investment in proportion to the investor's income/financial standing;

– guaranteeing the protection of personal data.

2) On the operative side of the platform:

– providing adequate information about risk factors, in particular the fact that investors may lose the entire invested amount (except in the case of donation-based financing);

– providing an adequately detailed description of the platform's operation;

– describing all fees and charges payable to the platform manager;

– providing an overview of the rights/obligations associated with the nature of the platform (e.g. regarding lending, the borrower's option for prepayment or repayment of the loan before its scheduled maturity);

– developing a complaints management procedure;

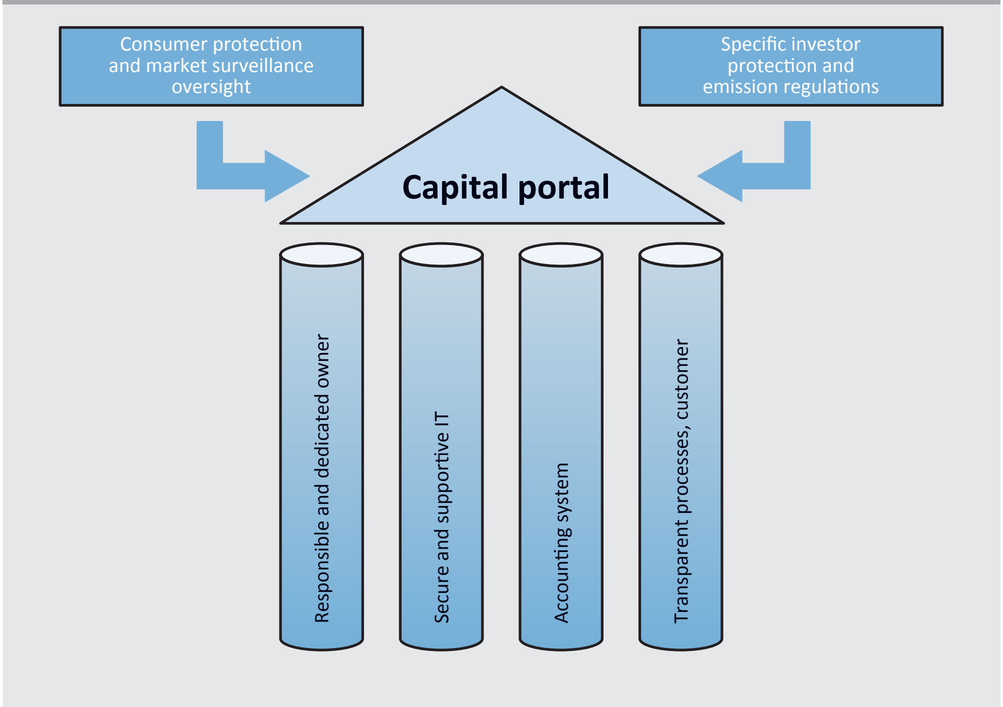
– defining disclosure requirements.

Besides investor protection rules, potentially efficient tools to consider are, for example, the registration or authorisation of platforms, a capital requirement or mandatory capital buffer, or the requirement of financial collateral (similar to the new institution of trust asset management).

As the domestic institutional system is being established, a strategic decision must be made as to whether it should be subject to the existing legislative framework or if separate regulation should be adopted. The main advantage of the latter is that this solution could truly ensure investor protection and the supervision of the institutional system (perhaps even by means of a prior authorisation procedure).

In addition to these considerations, the relevant activity of the European Commission should also be monitored, as potential future EU regulations may have a fundamental impact on the design of the domestic institutional system. The European Commission is exploring the status and risks of crowdfunding and the individual member state regulations in order that, should the need arise, an EU-level legislation can be enacted to ensure optimal operation of the internal market.[12]

Chart 5
The main pillars of the crowdfunding model



12 http://ec.europa.eu/internal_market/finances/crowdfunding/index_en.htm

Irrespective of the regulatory environment, the success of a portal depends on numerous factors: in order to attract a critical mass, the portal must become a “brand” – a stable, neutral, independent institution that is fully compliant with criteria of investor protection. The presence of prestigious owners behind the portal at its inception may also facilitate success. The existence of a secure and supportive IT background is of key importance. And, last but not least, crowdfunding portals must be supported by a safe settlement system.

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